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Public Policy and Venture Capital: The Canadian Labor-Sponsored Venture Capital Funds

by Ayi Ayayi*

Introduction

One of the most significant events of the last two decades in the Canadian venture capital industry was the emergence in the early 1980s under the federal and provincial governments' legislation of labor-sponsored venture capital funds (LSVCFs). This apparently was enacted to address the lack of available venture capital and to promote investment in Canadian small and medium-sized enterprises (SMEs), whose shares are not traded publicly. Today, there are 44 LSVCFs in Canada, which collectively account for approximately half of the \$20.134 billion of assets under management by all Canadian venture capital companies. The funds raised by LSVCFs have to be invested in SMEs with total assets of under \$50 million. In addition, while at least 60 percent of funding provided to SMEs has to be in the form of common equity, the rest can be in preferred shares or in unsecured subordinated debt.

LSVCFs operate in a manner similar to open-ended mutual funds and are capi-

talized by a large number of individual shareholders. Their propensity for investing in LSVCFs is encouraged by the generous provisions of the Canadian federal and provincial tax credits offered in exchange for committing this capital for eight years to inherently risky SMEs. In this respect, the LSVCFs have received heavy subsidization for their startup costs. In addition, LSVCFs' units are registered retirement savings plan (RRSP) eligible, and generous tax credits accrue to the purchaser of the units, without reducing their adjusted cost base. Even if the front-end subsidization and the RRSP eligibility are ignored, the tax credit alone means that these funds are working in the range of 60- and 70-cent dollars, depending on the province in which the fund operates.

The objective of this article is to provide a sound analysis of the distinctive features of LSVCFs in order to examine the effectiveness of their heavy tax subsidization on the Canadian venture capital market and on the Canadian economy in attaining public policy goals. If LSVCFs'

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